To: Members of the AER's Independent Panel (Panel)

From: Members of the AER's Consumer Reference Group (CRG)

16 March 2022

Dear Independent Panel Members

Re: DRAFT 2022 RATE OF RETURN INSTRUMENT (RoRI)

We are writing this letter in parallel to providing detailed advice to the AER in response to its *Rate of return: Overall rate of return, equity and debt omnibus – Final working paper* (December 2021) and *Rate of Return: Information paper and call for submissions* (December 2021) as well as a series of working papers published over the past year.

The purpose of our letter is as follows:

1. To introduce you to the CRG and outline our role in the AER's 2022 RoRI process
2. Share our understanding of the Panel's role
3. Share our thoughts around the AER's processes and forthcoming Draft RoRI decision in the context of our understanding of the Panel's role.

Introduction to the Consumer Reference Group

The CRG was established in June 2020 under the National Electricity Law (NEL) and National Gas Law (NGL) to assist the AER implement an effective consumer consultation process and provide independent advice to the AER on technical and consumer-related matters during the development of the RoRI. CRG members have extensive qualifications and experience in energy law and policy, economic regulation and finance, consumer advocacy and consumer research. Energy Consumers Australia (ECA) is also represented on the CRG.

The CRG meets with the AER on a regular basis, and with members of the AER board (the Network Committee) at key stages in the process, to discuss technical and consumer related matters. We also present our advice at the AER's public forums. Additionally, the AER and ECA provide us with resources to obtain independent specialist advice on technical aspects of the rate of return and to undertake consumer engagement activities. This includes consumer surveys and workshops, master classes and interviews with consumer and industry representatives and with independent investors.

Our understanding of the role of the Independent Panel

We understand the Independent Panel's role is to advise the AER whether it has:

- undertaken an effective review
- engaged with the material before it with an open mind
- reached a decision that is supported by stated reasons and the information available

And ultimately answer the following two questions:

1. In the panel's view, is the draft instrument supported by evidence and reasons, taking into account competing factors such as accuracy, consistency, accessibility and transparency?
2. In the panel's view, is the draft instrument likely to contribute to the achievement of the National Electricity Objective and National Gas Objective?

Matters for the Independent Panel to consider

There are many features of the AER's 2022 RoRI process that are a significant advance on the 2018 RoRI process. The AER has clearly reflected on the 2018 RoRI process, and in response has undertaken extensive and genuine consultation with the CRG and other stakeholders since mid-2020.

The AER's series of working papers, published over the course of 2020 and 2021, has helped clarify the important issues in the rate of return debates and the AER's evolving position on these issues.

We also appreciate the AER's increasing interest in our consumer research and engagement activities, although the challenge remains for the AER to take account of these findings in the making of the 2022 RoRI. More recently, we have had a number of constructive sessions with the AER and Network Committee to further consider this challenge.

While we agree with the AER on many of its 'positions', nevertheless, we have identified a number of matters of concern that we would like the Independent Panel to consider. We have summarised these concerns below in two categories, namely: (i) when the AER is proposing a change to the 2018 RoRI; and (ii) other process related matters. In raising these matters, however, we also recognise that the AER may address some of our current concerns in its June 2022 Draft RoRI.

Matters where the AER is proposing a change to the 2018 RoRI:

- The term of the risk-free rate (RfR): The AER has indicated it is open to adopting a five-year term for the RfR (a key element in the return on equity), rather than its long-standing practice of using a 10-year term.
- Estimation of the Market Risk Premium (MRP): In the 2018 RoRI, the AER relied almost exclusively on the long-term historical averaging approach to estimate the MRP. The AER is now considering whether to give additional weight to alternative approaches such as the various dividend growth models (DGMs).
- Use of a weighted trailing average (WTA) for debt: The 10-year unweighted TA has been adopted since the 2013 Rate of Return Guideline, and the unweighted TA is still in a 10-year transition period. The AER has indicated it is open to adopting a WTA approach, at least for some networks.
- Financeability cross-checks: In its past reviews, including its earlier reviews in 2020 and 2021 for the 2022 RoRI, the AER rejected the use of financeability tests as a cross-check to its overall rate of return allowance. In December 2021, the AER changed its view and stated its preferred position was to include financeabilty cross-checks.

The CRG considers that to date the AER has not always adequately explained the reasons for the proposed changes and why the changes would lead to a better rate of return decision. Nor has the AER fully explored the implications of each of the proposed changes for other rate of return parameters and the overall rate of return.

In addition, the 'devil is in the detail', particularly for the proposed changes to the MRP, WTA and financeability cross-check. Given this, there must be sufficient time allowed for meaningful consultation with stakeholders on the detail including on the potential interactions with other rate of return parameters. The AER's timetable does not appear to allow sufficient time for such detailed consultation.

Other process matters of concern to the CRG

- Data used in estimating the equity beta: The AER's preliminary position is to continue to retain the comparator set, which it adopted in 2013. This set includes companies that are now either not listed, or defunct, and have been so for over 10 years. The AER has not clearly explained the risks and benefits of continuing to rely on data from these long-defunct businesses in preference to using a more current, albeit smaller, sample of comparators.
- Consumption efficiency: The NEO and the NGO require the AER to consider efficient investment in, and efficient operation and use of the network. The CRG made several submissions to the AER on the need for the AER to consider both efficient investment in, and usage of, the network (i.e., 'consumption efficiency'). The AER has since acknowledged the need for further investigation. However, neither the Final omnibus paper nor the Information paper mentions how it will progress this matter before the Draft RoRI.

In summary, the CRG would welcome the Independent Panel reviewing whether the AER's Draft RoRI adequately considers the evidence for change and demonstrates that the proposed change will lead to a materially better rate of return decision on the individual parameters, and as a whole. We would also appreciate consideration of whether the AER has allowed sufficient time for meaningful consultation with stakeholders on the specific details and implementation issues of any proposed changes.

The Executive Summary of the CRG's advice to the AER on its Final omnibus paper and Information paper is attached to this letter. Our full submission to the AER provides further details.

Overall, our current advice to the AER is to continue with the approach it adopted to the rate of return in the 2018 RoRI, with a number of important exceptions highlighted in our submission. As noted above, we also recognise that the AER may address a number of the matters raised in this letter in the 2022 Draft RoRI.

Yours faithfully

[redacted]

Bev Hughson,

Chair, Consumer Reference Group

cc: Mr Warwick Anderson,
General Manager, Network Financing and Reporting
Attachment: Copy of Executive Summary of the *CRG's advice to the AER on the Final Omnibus Working Paper and Information Paper*

Attachment

Executive summary - CRG Response to the AER's December 2021 Information paper

The CRG is pleased to provide this advice in response to the AER's December 2021 *Information paper and call for submissions (Information paper)*. As we approach the final stages of the 2022 Rate of Return Instrument (RoRI) review, the role of judgment in the AER's decision is being brought into ever sharper focus. This is evidenced by:

- The lack of consensus amongst the experts in the concurrent expert sessions on the best method to estimate key parameters – or how to take multiple methods into account
- The range of open options remaining in the lead-up to the draft Instrument – including several debates that had apparently been concluded at the time of the 2018 RoRI
- The challenges of navigating an external environment characterised by macroeconomic uncertainty and an accelerating energy transition.

The CRG considers the best way for the AER to exercise its judgment is to, as far as possible, maintain the long-term focus it established in the 2018 RoRI. This option is most consistent with the long-term interests of consumers, the AER's assessment criteria and the CRG's consumer-oriented principles. Our reasoning for this position is set out in detail in Chapter 1[1] of our advice and is summarised as follows:

- There should be a high bar for change, recognising a stable regulatory framework is in customers' long-term interests
- A long-term approach is also aligned with the interest of the long-term investors (pension funds, private equity and governments) that increasingly dominate the sector
- Regulatory risk is increased when attempting to capture transient market conditions in a binding rate of return that will have application for up to a decade
- No evidence has been provided that the 2018 RoRI is having a detrimental impact on the ability of NSPs to raise finance; to the contrary these assets remain highly sought after by global investors.

We recognise that the 2026 RoRI may require greater change, due to the near-complete delisting of privately owned networks, and the consequent paucity of market data, which impacts several RoRI parameters. Energy transition may also be a driver of change. However, in both cases, there is much work to be done before the AER responds by changing its approach to estimating the cost of capital. Analysis of the information deficit and potential remedies is required, and challenges to the regulatory framework need to be considered holistically before concluding whether changes to the RoRI are an appropriate solution. This is another reason to avoid *ad hoc* changes in the 2022 RoRI.

Our views are consistent with, and informed by evidence from consumers, consumer representatives and independent investors (see Chapter 2).

Chapters 3 to 9 in our advice to the AER, set out our views on individual parameters and the key questions raised in the AER's *Information paper*. Our specific views reflect our overall concerns

[1] The Chapter and Section numbers referred to in this attachment relate to location of more detailed information

outlined above. Mostly, we recommend no change from the 2018 RoRI, but we have identified some areas where we consider the case for change is justified.

Term of the risk-free rate

We find Dr Lally's 2021 report[2] to the AER (Section 3.3)[3] does not support his proposition that the term for the risk-free rate should match the term of the regulatory period (Sections 3.4 to 3.5). Accordingly, the term for estimating the return on equity remains a matter of judgement. While previous reviews consistently found in favour of a ten-year term, the AER left few realistic options on the table when it decided in December 2020 to shorten the estimation term for inflationary expectations. On that basis alone, the CRG accepts the AER should now align the term for the return on equity with the estimation term for inflationary expectations. It is essential that the AER explain if and what impacts this change has on the assessment of other parameters and the materiality of the overall impact on consumers (Section 3.6).

Market risk premium (MRP)

The AER's challenge in estimating the MRP is significant, given the true MRP is unknowable, and all estimation methods have their weaknesses. However, neither the AER nor stakeholders have provided any empirical evidence that the prevailing approach has a detrimental impact; so the prevailing approach, which puts most weight on the Historical Excess Returns (HER) method, should be retained. This method is the most appropriate for long-lived assets with long-term investors, and when the impact of the estimate endures for up to a decade due to the application of the binding RoRI (Section 4.4.1).

Dividend Growth Models (DGMs) are subject to wide variability making them unsuitable for point estimates of MRP in the context of the AER's regulatory task. Other methods and indicators have significant flaws that could lead to misleading or unreliable results and should not carry significant weight (Section 4.4.2).

Overall, and based on the latest data, we consider the 2018 point-estimate represents the upper bound of a reasonable MRP estimate for the 2022 RoRI (Section 4.6).

Beta

The AER should attach reduced weight to estimates of beta that derive from firms that have delisted or firms for whom regulated revenues are a small proportion of their overall revenues (Section 5.2.3). It should not seek to compensate for the small number of remaining comparators by including non-energy infrastructure firms or international energy firms in the comparator set for estimating the value of beta in the 2022 RoRI (Section 5.2.3). The AER should use the longest, reliable estimation period when estimating the value of beta (Section 5.2.1).

Return on debt

We accept the AER's findings that the Energy Infrastructure Credit Spread Index (EICSI) provides evidence of 18 basis points of outperformance versus the trailing average benchmark, 14 basis points

[2] Lally, M., *The appropriate term for the allowed cost of capital*, April 2021

for term and 4 basis points for other factors. The development of the EICSI is an invaluable analytical tool and its use should be continued (Section 6.5).

Given the relatively low outperformance, and the AER's apparent belief that transition is necessary when adjusting for term, we accept adjustment to the benchmark is unlikely for this RoRI (Section 6.4).

Nonetheless, the AER should also consider that it has identified and is allowing continued outperformance when considering the overall rate of return and relevant cross-checks such as financeability (Section 6.4).

The AER should signal in the strongest terms that the trailing average should continue to be applied through the interest rate cycle. This is the best way to defend against pressure to abandon it when interest rates begin to rise (Section 7.3).

The AER should not put significant weight on the risk of policy intervention. Second-guessing government policy actions has no place under the energy laws or rules and risks distorting the AER's decision-making. Regardless, interventions such as public financing of capex driven by decarbonisation or other policy objectives (including ISP projects) may be the best response from a consumer perspective (Section 7.4). Accordingly:

- There is no case for introducing a capex weighted average for the great majority of networks.
- For transmission businesses faced with significant new capex, there are other options available for addressing genuine financing issues that are more direct and less costly to consumers than introducing a capex weighted trailing average or amending the rate of return (Section 7.6).

Cross-checks and overall rate of return

We agree with the AER that cross-checks should not have a determinative role and should be used with caution.

We do not consider *ex ante* financeability testing, of the sort carried out by regulators such as IPART and Ofgem, to apply to a standalone rate of return. Regardless, the detailed design of such a test would require extensive consultation in its own right as IPART has done, which the AER has not had the opportunity to undertake before the 2022 RoRI decision. We interpret the AER's *ex post* financeability test of extant rate of return decisions as evidence that those decisions have provided NSPs with at least an adequate rate of return (Section 8.4).

We consider Regulated Asset Base (RAB) multiples capable of supplying relevant evidence and urge the AER to perform this cross-check using plausible indicative ranges for the factors that could result in RAB multiples greater than one (Section 8.5).

We recognise the challenges in constructing an appropriate analytical framework for using historical profitability as a rate of return cross-check. Given its importance to customers in evaluating the overall regulatory framework, at a minimum we recommend it constitutes a qualitative "conditioning variable" that the AER takes into account when applying its judgment, particularly given the AER's own evidence of a consistent pattern since 2014 of over-recovery on the key profitability measures across almost all networks. (Section 8.6)

We agree that scenario testing can be a useful cross-check of the robustness of the AER's rate of return decision, but we caution that great care must be taken in the process of selecting the relevant forecasts to ensure scenario testing is applied symmetrically. The AER should also clarify how it seeks to interpret the output of scenario testing (Section 8.7).

We see no case for changing the benchmark gearing ratio or the value of gamma (Section 9).

When the AER is considering cross-checks and their role in its decision, it should also look at them collectively. That is, the AER considers whether a specific cross-check reveals under- or over-performance against the AER's benchmarks across time; if this outcome is material, and whether similar results are observed across the majority of businesses. The AER can also consider if different cross-checks indicate the same conclusion about under- or over- performance.